OVERSIGHT OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY

HEARING

BEFORE THE

SUBCOMMITTEE ON CAPITAL MARKETS AND GOVERNMENT SPONSORED ENTERPRISES

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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WITNESSES

FRIDAY, MAY 1, 2015

APPENDIX

OVERSIGHT OF THE FINANCIAL INDUSTRY REGULATORY AUTHORITY

Friday, May 1, 2015

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON CAPITAL MARKETS AND
GOVERNMENT SPONSORED ENTERPRISES,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 10:48 a.m., in room HVC-210, Capitol Visitor Center, Hon. Scott Garrett [chairman of the subcommittee] presiding.

Members present: Representatives Garrett, Hurt, Royce, Neugebauer, Huizenga, Hultgren, Poliquin, Hill; Maloney, Sherman, Lynch, and Himes.

Chairman GARRETT. Good morning. The Subcommittee on Capital Markets and Government Sponsored Enterprises will come to order. I appreciate everyone's indulgence for votes, for those important pieces of legislation.

Today's hearing is entitled, "Oversight of the Financial Industry Regulatory Authority." I will begin with opening statements and then turn to our panel.

I now yield myself 3 minutes.

Today we will hold, as I said, an important hearing, to provide for much-needed oversight of the Financial Industry Regulatory Authority (FINRA). But despite its status as a self-regulatory organization (SRO), some would argue that it hardly resembles what would many call an SRO, and is what now appears to be more of a quasi-government regulator. Some even call it a deputy SEC.

Indeed, its recent actions are closer to that of ever-expanding Federal bureaucracies that we have become accustomed to now in Washington, that seek to go further into people's lives and businesses.

And so, despite FINRA's enforcement of rules for the broker-dealer community that it regulates, it recently has come out in favor of the SEC moving forward with a uniform fiduciary standard, a sentiment shared by SEC Chair Mary Jo White.

I should point out that when Chair White was before the full Financial Services Committee in March, she was unable to provide this committee with any studies or any other data, especially as it relates to the proposal's impact on low- and middle-income investors, which convinced her of the need for the new proposal in the first place.

So I hope that Mr. Ketchum can elaborate today on the studies and any empirical data that he may have reviewed which has per-

suaded him and FINRA that the SEC should move forward on sweeping regulations and reconstruction of our security laws.

As I previously noted elsewhere, and in other conversations, FINRA's comprehensive automated risk data system, also called CARDS, is a solution in search of a problem. Even after changes to the original proposal, I remain far from convinced that this costly, intrusive, and burdensome proposal is actually needed. The costs will far outweigh any potential benefits, and will further squeeze out small broker-dealers who are already facing increased regulatory compliance costs.

Additionally, CARDS would establish a new government database that would retain sensitive information about millions of Americans that can be, as we have been told, re-engineered to determine their personal identity. This, as some have said, amounts to the CARDS proposal being "a few cards short of a full deck."

As FINRA is attempting to stand up CARDS, it is also bidding to become the operator of something called the consolidated audit trail (CAT). In bidding for CAT, FINRA is in a unique position to the other bidders on this proposal.

Why is that? Because it sits on the SRO committee that will recommend a winner to the SEC. This would appear to be a blatant conflict of interest.

But, notwithstanding that, I think having a single financial regulator with the data held by CAT and CARDS, should give every American some pause.

In all, FINRA continues to step far beyond, I believe, the bounds of its originally intended jurisdiction and into personal investing decision-making of everyday Americans. It is this committee's duty to ensure that FINRA supplements, but does not supplant, the SEC. So, with that said, I want to thank the panel, which consists of one witness, Mr. Ketchum, for your appearance today at the hearing.

The gentleman from Massachusetts is now recognized for 2 minutes.

Mr. LYNCH. Thank you, Mr. Chairman. I appreciate your indulgence.

I think there has been some recent activity that, indeed, does call into question FINRA's conduct. While some may suggest it is hyperactivity, I think that the events going back to the May 6, 2010, "flash crash" when the Dow Jones Industrial Average rapidly dropped about 600 points in 5 minutes before quickly rebounding, that event has brought further evidence to light.

Recently, on April 21, 2015, the CFTC and the Department of Justice announced that the agencies were bringing civil and criminal charges, respectively, against Navinder Singh Sarao, a U.K. trader who had been manipulating the global financial markets from his home for years, for allegedly helping to cause the May 6, 2010, "flash crash."

As reported in the New York Times, Mr. Sarao is accused of entering and withdrawing thousands of orders, worth tens of millions of dollars each, on hundreds of trading days, in an attempt to push down the price of futures contracts tied to the value of the Standard & Poor's 500, a practice known as "spoofing."

Once the price fell, Mr. Sarao would buy the contracts and reap the profits. However, on the day of the "flash crash" on May 6, 2010, prosecutors contend that Mr. Sarao placed large orders repeatedly over several hours, leaving the market vulnerable to big moves when another big trade came in from an investor in the United States.

Reports indicate that the regulators completely missed Mr. Sarao's activity, because they weren't looking at complete data. As a result, it took regulators 5 years—5 years—to track down the actual culprit of the "flash crash."

The equity markets have rapidly evolved. Now, there are thousands of stocks and over 1,000 exchange traded funds (ETFs) trading on 11 stock exchanges. There has been the introduction of over 40 dark pools.

And I think what we would like to hear from the witness is whether the fragmentation of liquidity has hurt your cross-market surveillance methods, and do you think there are too many venues in which to trade securities?

FINRA is responsible for regulation in the securities industry, and can reach across securities markets centers to look for manipulative behavior. And I am just wondering with the evolution of the markets, does FINRA still have the ability to do that, to reach across asset classes, like futures and currencies.

Since many strategies today employed by proprietary traders reach across various asset classes, do you think it would make sense for the CFTC and the SEC to work more closely together and share that information? Those are some of the questions that I think the "flash crash" investigation has raised. It will be interesting to hear the answers from our witness. And I yield back the balance of my time.

Chairman GARRETT. The gentleman's time has expired.

Mr. Hurt is recognized for 2 minutes.

Mr. HURT. Thank you, Mr. Chairman. Mr. Chairman, I want to thank you for holding today's hearing. I am pleased that the subcommittee has taken the time to conduct oversight of the Financial Industry Regulatory Authority and its activities. Making sure that we have fair and effective regulation is vital to maintaining efficient capital markets, especially for smaller firms that are subject to FINRA's supervision.

While a larger firm may be able to absorb FINRA's compliance costs, smaller broker-dealers are often hampered by them. FINRA's proposed CARDS initiative is one example of an idea that I believe is too costly and burdensome, particularly for smaller firms.

Investors in both Virginia's Fifth District, my district, and across the country rely on FINRA to regulate broker-dealers in a responsible way. FINRA also has responsibility to operate in a fair, consistent, and transparent manner, given the authority that it exercises.

FINRA must be mindful of the potential economic impacts its rules may have, particularly at a time when economic growth remains vitally important.

I believe FINRA should focus on streamlining its duplicative systems and improving its operations, so as to better serve the broker-dealer community and their customers. I hope that today's hearing

gives us an opportunity to examine the work that FINRA is doing and the ways in which we can ensure that broker-dealers continue to efficiently regulate and to remain vibrant for years to come.

I look forward to the testimony of Mr. Ketchum, and I thank him for his appearance before the subcommittee today.

And, Mr. Chairman, I yield back the balance of my time.

Chairman GARRETT. The gentleman yields back.

The gentlelady from New York is recognized for 3 minutes.

Mrs. MALONEY. Thank you, Mr. Chairman, for holding this important hearing.

We talk a lot about investor protection on this committee, and FINRA plays a central role in protecting investors in our securities markets. Investor protection takes many forms, but in general we focus on two main areas: first, ensuring that investors have enough information to make fully informed investment decisions; and second, making sure that investors are treated fairly by the securities professionals with whom they deal. These categories do overlap.

Sometimes investors get their information about a security from their broker. In that case, ensuring fair treatment means making sure that the broker discloses all the pertinent information to the investor and it is in this second category of investor protection, ensuring fair treatment, that FINRA plays an enormously important role.

Every broker and brokerage firm that sells securities to the investing public must be licensed and registered with FINRA. The regulation of broker conduct is extremely important because of the inherent informational advantage that brokers have over ordinary investors.

Brokers by their very nature have access to a great deal of information that investors do not have. Most importantly, since brokers take orders from both buyers and sellers all day, they know which products are in demand.

As a result, it is important that appropriate standards are in place to ensure that brokers don't use that informational advantage to the detriment of investors. That is where FINRA comes in. FINRA ensures that brokers don't mislead investors and that they don't sell investors products that are inappropriate for them or are deliberately designed to be too complex for them to understand.

And while this is a critically important role, it is not the only role that FINRA plays in our markets. It also plays a key role in market surveillance by identifying red flags and trading patterns that suggest possible insider trading or fraud.

For instance, if there is an unusual amount of buying in a particular stock right before a company announces it is being acquired, it is FINRA that usually detects that activity and refers it to the SEC's Enforcement Division.

In 2014 alone, FINRA referred over 700 matters to the SEC for possible enforcement. So without these kinds of red flags and referrals from FINRA, the SEC would be significantly less effective.

Also, it is an independent relationship and one that we should periodically examine to ensure that everything is working properly. That is why we are here today to conduct this necessary oversight of FINRA.

So I look forward from hearing from our witness, and I yield back the balance of my time. Thank you for calling this hearing.

Chairman GARRETT. I thank the gentlelady.

Now, we turn to our witness, Mr. Richard G. Ketchum, Chairman and CEO of FINRA. Thank you very much for your indulgence and your patience, and you are now recognized for 5 minutes.

You have been here before, so you know that your complete written testimony has already been submitted to the record. And you are recognized for 5 minutes.

STATEMENT OF RICHARD G. KETCHUM, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, FINANCIAL INDUSTRY REGULATORY AUTHORITY (FINRA)

Mr. KETCHUM. Chairman Garrett, Ranking Member Maloney, and members of the subcommittee, I am Richard Ketchum, Chairman and CEO of the Financial Industry Regulatory Authority, or FINRA.

On behalf of FINRA, I would like to thank you for the opportunity to testify today.

FINRA oversees approximately 4,000 brokerage firms and over 600,000 registered brokers. FINRA's programs range from registering individuals to examining securities firms, writing rules, enforcing those rules and the securities laws, and educating the investing public.

FINRA carries out this work under authority from Federal law and oversight by the SEC. Our work is informed by a board and advisory committee structure that incorporates both public and industry representation.

In addition to regulating brokers and brokerage firms, FINRA monitors approximately 99 percent of all trading in U.S. listed equities markets, or nearly 6 billion shares traded each day. In fact, FINRA's market surveillance systems process approximately 30 billion market events each day to closely monitor trading activity in equity options and fixed-income markets in the United States.

And I would note to the question raised earlier in the statements that FINRA has, for decades, looked at order information of surveillances, and for a period of 5 years, has had surveillances with respect to spoofing and layering that has resulted in multiple disciplinary actions.

The programs we operate are continually evolving to improve and reflect relevant changes in industry operations and technology.

In my written statement, I describe our rulemaking process, as well as the economic analysis we build in through our Office of the Chief Economist, as well as our retrospective rule review process, which has just resulted in the first set of rule changes approved by our board in April.

Our examination program has shifted over the past few years to a far more risk-based system, one that is built on gathering information prior to examinations, evaluating the risk areas posed by an individual firm, and focusing resources on the areas where the most risk to investors lies.

Alongside these efforts, however, we have maintained our commitment to regular on-site examinations, and we conduct these

exams on cycles that range from annually to every 4 years, depending on the firm.

We have also enhanced programs such as our Office of Fraud Detection and Market Intelligence, and added new ones, such as our high-risk broker program, in an effort to develop new ways to quickly identify and address potentially harmful conduct.

When we find this conduct and bring disciplinary actions, we focus not just on fines, but importantly, on restitution to harmed investors. Last year, we ordered over $32 million in restitution to customers. And cases brought by other authorities based on referrals from FINRA resulted in even more money returned to investors.

In the market regulation area, the primary challenge is to ensure that regulation is effective in today's increasingly fragmented marketplace. Through our work for exchange clients, FINRA has been able to aggregate trading data across the markets to conduct comprehensive cross-market surveillance. This cross-market surveillance enables FINRA, in partnership with exchanges and the SEC, to better protect investors and promote market integrity.

FINRA also is working to design surveillance programs that will span equities and options markets together to identify potentially manipulative conduct across products.

And, of course, when the SEC's consolidated audit trail is functional, that will be the most complete picture of market activity and a vital tool for effective regulation.

Complementing these regulatory and examination programs are efforts to enhance the information available to investors.

FINRA created important transparency for the corporate bond market with the launch of our trade system over a decade ago, significantly reducing spreads in that market. We have now expanded trades to include agency debentures and many asset-backed securities, with more to come over the next 12 to 18 months.

We also recently began collecting and making public reported volume and trade count information for all dark pools. Market participants, investors, regulators and academics are now able to see with unprecedented granularity volume information and trends regarding dark pool trading on a security by security basis.

Finally, I would note that 10 years ago FINRA established the FINRA Investor Education Foundation to provide investors with useful information and tools. Since its inception, the FINRA Foundation has approved nearly $100 million in grants in targeted projects. And these efforts have led to tangible benefits for investors in all parts of the country.

In all of these areas and others, FINRA remains committed to working closely with investor and industry representatives, fellow regulators, and our oversight committees, as we continue to carry out our mission of protecting investors and safeguarding market integrity.

I appreciate the opportunity to testify today, and I would be happy to answer any questions you may have.

[The prepared statement of Chairman Ketchum can be found on page 30 of the appendix.]

Chairman GARRETT. Great, thanks. I appreciate your testimony.

I will now recognize myself for 5 minutes for some questions.

So the predecessor of FINRA was the NASD. I would argue, and many would argue, that the NASD was a true self-regulatory agency. And I would argue that FINRA today is neither a true self-regulator, nor is it a government regulator. It acts more like a deputy of the SEC, than it does as a self-regulator.

In the beginning of this year, a witness from the Mercatus Center, Hester Peirce, suggested several ways to look at this issue that I just laid out, and suggested several ways to improve—maybe to restore FINRA's structure, if you will, and to improve its accountability, and, as she put it, "to reshape FINRA into a true self-regulatory organization." The regulators actually run by the industry it regulates and allowing the emergence of competing self-regulatory organizations.

So I will give you a minute here to respond.

Should the membership, if you will, of FINRA have a greater say in its operations, a greater say in its organization, a greater say in the policies that it proposes? A greater say in the rule proposals? A greater say in its agenda, than it does now? And I understand—and you laid out in your written testimony—the advisory committees and that sort of thing, that exist today. So I am asking, should there be greater say than what already exists as in the current structure?

Mr. KETCHUM. The short answer would be that I think the balance is correct today. I was honored to work and serve at the NASD throughout the 1990s.

Chairman GARRETT. Right.

Mr. KETCHUM. And I saw the evolution of the NASD into a balance that I think is very similar to FINRA in those 1990s.

I think what is left is a board that has a majority of public members, but has industry members that reflect each of the segments of the industry to ensure that there is input with regard to any rules or questions with respect to our program.

Chairman GARRETT. So this—

Mr. KETCHUM. That is built across committees, both of small member firms, and I recognize the points made earlier that absolutely require our attention, as well as committees on a subject matter basis. So I believe what—

Chairman GARRETT. But those committees—and there are a whole slew of them. I understand that.

Mr. KETCHUM. Yes.

Chairman GARRETT. Would you honestly say that those committees are the ones that actually shape the policy and the rules that come out—that get proposed?

Mr. KETCHUM. Yes, I would say they have a great deal of input. The decisions are fundamentally decisions that have to be made by the staff and the board, which is absolutely the way it was at the NASD.

Chairman GARRETT. So where—

Mr. KETCHUM. But the input of those committees get directly communicated to the board.

Chairman GARRETT. Right, so where—

Mr. KETCHUM. Not something we do, but directly communicated to the board.

Chairman GARRETT. So since you were around both times, now and then, where today do the actual ideas or the proposals—where do the actual proposals come from? Do the actual proposals come from the committees? Or, as you just said, the staff and the board? Does the staff say, "Here is the idea. Here is the proposal," and then go to the committee and say, "Hey, give us your two cents on this?" Or it is the other way around? Is it from the bottom up? Yes?

Mr. KETCHUM. Chairman Garrett, I think the answer is both. We get ideas from committees that lead to rulemaking. We get reaction to suggested proposed rules from committees that profoundly change and adjust what the rulemaking is because of the valuable input they provide—

Chairman GARRETT. And what—

Mr. KETCHUM. —as well as input from the standpoint of investors.

Chairman GARRETT. And so, to take a particular example, such as the CARDS idea, where did that come from? Did that come from the bottom up, from the small broker-dealer suggesting that? Or did that come from staff and the board?

Mr. KETCHUM. No, the CARDS proposal came from staff and its experience in using data analytics with respect to the exam program.

Chairman GARRETT. I'm sorry?

Mr. KETCHUM. It—

Chairman GARRETT. Wait, I just—

Mr. KETCHUM. —the CARDS proposal came from the staff as a result of our experience in using our data to analyze and try to target our exams, and looking to ways to do that more effectively from the standpoint of an early warning system.

The proposal has consistently evolved as a result of comments made by folks in the industry.

Chairman GARRETT. And do the committees at the end of the day have a—I don't want to use the term "veto," which is too strong of a term, but something akin to that when these things come down?

Mr. KETCHUM. No, and they should not. Fundamentally, FINRA should—and what FINRA provides should be an independent organization that is informed by the industry, that provides a level of formal and informal input that is dramatically different than government, but its decision should be independent.

Chairman GARRETT. So why do you think it is when I meet with a lot of the smaller guys, that they say that they feel that FINRA is something with which they have no communication, no contact, no influence? That it is just—my word, not theirs—"aloof, separate from them?" Why do you think I get—why do I hear that from the folks?

Mr. KETCHUM. I feel badly that you do get it from the folks. Small business—small broker-dealers have a challenging environment. We try to interact with them regularly. Both I and my staff meet with small firms around the country. And we have a small firm advisory board that regularly changes. It includes both members who are elected by small firms, as well as additional members who provide great value. So we try to get as much—and we have three representatives of small firms on our board as a matter of requirement at all times.

So, I do believe small firms provide a lot of input into FINRA.

Chairman GARRETT. All right. My time has expired. And I also want to recognize Mr. Hill for his expertise and experience on these matters, and his advice to me on these issues going forward.

Thank you, Mr. Hill.

With that, I now recognize the gentlelady from New York, Mrs. Maloney.

Mrs. MALONEY. Thank you. And thank you, Mr. Ketchum, for your testimony. I would like you to comment on this article that was in The Financial Times earlier today. It said that U.S. banks push for a delay in reporting corporate bond trades. And, apparently, they are saying that there is a lack of liquidity in the bond market. And that if you delayed your 15-minute requirement of reporting trades to the TRACE system, it would help the liquidity problem.

So I would like you to comment on this proposal, and on whether or not you believe there is a lack of liquidity in the corporate bond market or municipal bond market. And do you think that a delay in the reporting time for large corporate bond trades would improve liquidity?

Mr. KETCHUM. We are reaching out to the industry. So it is an excellent question, Ranking Member Maloney. And we regularly have conversations over the impact of TRACE reporting.

As you know, there have been dramatic changes with respect to the fixed-income market in recent years. Many of them come in the reaction of the failures and market impact coming out of the credit crisis.

That has led to much higher capital requirements, the Volcker Rule that limits the ability for proprietary trading with respect to bank holding companies, a range of other issues that have all had significant impact from the standpoint of the liquidity of the fixed-income market.

So we will—most of the comments we have heard focus on the least actively traded issues. We are going to do—I think they should be analyzed from a matter of data, and we are going to do additional analytical work to look at whether there has been a measurable change in liquidity with respect to those types of issues. And consider very closely several of the suggestions, most of which focus on the timing with regard to the reporting of larger trades.

I will note the other side, though, and I know you are very familiar with this, which is TRACE has resulted in the dramatic reduction of spreads that, from the standpoint of the fundamental retail investor or those of us who invest indirectly through mutual funds, has dramatically reduced the cost of trading in the fixed-income market.

That is not something we should want to lose anymore than the transparency TRACE provides to allow you to evaluate the quality of the execution you receive.

But we take liquidity concerns seriously, and we will do both statistical analyses and reach out more to the industry.

Mrs. MALONEY. Thank you.

I would also like to ask about the report that FINRA and the SEC recently published on the treatment of investors who are sen-

ior citizens. In that report, you found that some brokers are still making investment recommendations that are totally inappropriate for seniors. And as you know, we have had such a low interest rate return since 2008. And while I believe that this monetary stimulus has been necessary to lift the economy out of our deep recession, low interest rates mean low yields, and that has hurt the savings accounts and conservative investments of our seniors. And they usually rely on it.

So my question is, do you think that this extended low-interest rate environment is the main reason why broker-dealers have been recommending riskier and possibly unsuitable securities to our senior centers—in our senior centers and our senior citizens?

Mr. KETCHUM. It is an excellent question, and yes—

Mrs. MALONEY. And senior investors?

Mr. KETCHUM. I think it has been a contributing factor for exactly the reasons you so eloquently mentioned.

Senior investors, who are often dependent on a fixed-income and very dependent on their investments, have been dramatically impacted with regard to low yields. The temptation to reach for higher yields with respect to a range of complex or less liquid investments is very real. And the temptation of the industry to sell them, even when they are not suitable, is something that we have a great concern of, and we have certainly seen in some instances.

I would emphasize that generally speaking, the industry is very careful from that standpoint and has worked, I think, considerably harder from the standpoint of the quality of controls and disclosures they use.

But the concerns are real, the abuses have happened, and our focus is very much on senior investors. And indeed, we just, with Susan Axelrod, who is sitting right behind me, her leadership opened up a senior help line to try to give seniors the opportunity to have a place to go to ask questions, whether about their accounts or otherwise.

So, the concerns you raise are very real.

Mrs. MALONEY. Thank you.

Chairman GARRETT. Thank you.

The vice chairman of the subcommittee, Mr. Hurt, is now recognized for 5 minutes.

Mr. HURT. Thank you, Mr. Chairman.

Thank you, Mr. Ketchum, again, for appearing before our committee and for the contact that you have been in with us as we try to work through some of these issues.

Obviously, from the big picture, when we look at proposals such as the CARDS proposal, the uniform fiduciary standard proposal, what we are trying to balance—and I know you are sensitive to this, but what you are trying to balance, it seems to me, is a regulatory scheme that is efficient and is necessary, on the one hand, and that, on the other hand, does not limit consumer choice and jack up consumer cost, because that is ultimately what happens, it seems to me, when you have over-regulation.

Following up on Mrs. Maloney's questions, one thing I would point about the uniform fiduciary standard—and I ask you to comment on this—is that if there are abuses already under the suitable

standard, it seems to me that you all already have the power to be able to go after folks who violate those standards.

And if that is the case, then why would—and we all know broker-dealers have all kinds of requirements they have to live up to—we risk the possibility of higher costs and fewer choices by imposing a higher standard that is not necessary?

Mr. KETCHUM. Congressman, first, I want to say I think you set out the balance absolutely correctly, and I completely agree with the way you phrased it. I think that has to always be the way we look at each initiative, certainly from a rulemaking standpoint.

On the fiduciary standard, I think some of the references here refer to my statements in a variety of conferences saying that I believe that the right way to move forward is with Chair White's leadership, for the Commission to look at the possibility of a balanced fiduciary standard across all products and that I regret the possibility of having different standards with regard to the Labor Department proposal and what exists in the securities market.

I absolutely agree with you that the present regulatory structure is strong. We bring, as was noted, over 1,000 enforcement cases each year. The rules, with respect to suitability and supervision that exist in the securities markets for broker-dealers, combined with regular examinations and oversight with regard to FINRA and the SEC are things that investors should feel very good about and result in strong protection.

Mr. HURT. Let me quickly ask you a couple of questions about the CARDS proposal, relating to a study that was mentioned in a Wall Street Journal piece this morning, something that has been referred to in the past, relating to the MIT study, that you can take—you don't need personally identifiable information if you have date, location, and four transactions.

What is your opinion of that study, and how does that affect FINRA's thinking on the proposal?

Mr. KETCHUM. As we have said in the written statement, we absolutely are committed to take no steps with respect to creating a new centralized database where there is significant risk with respect to reengineering. One of the values of the comment process was it brought things to our attention and raised issues. We have stepped back very much to evaluate those things.

And as I indicated in the statement, we don't plan to move forward with CARDS—

Mr. HURT. Until those concerns are addressed. But what does that mean? Can you—what can you share with us in terms of what that means when you say, "our concerns are addressed?" Because I think that we would like to know, to have some idea of what the timeline is and how you get to that place.

What are the things that you are looking for in terms of addressing those concerns, specifically?

Mr. KETCHUM. Let me be, first, absolutely clear. I think the first step in the goal around CARDS, how it is delivered, is to create a more effective early-warning system so that we can identify serious frauds, serious sales-practice matters that we can step in and react more quickly to—

Mr. HURT. Got it.

Mr. KETCHUM. —before investors are hurt. We don't believe that account-level information is necessary for that, as we have reflected on it.

So we are stepping back, having a number of conversations—

Mr. HURT. What are the security, because two issues are—it seems to me there are costs and the need for it, the cost-benefit issue.

But also, the security issue is significant. And how important is that?

Mr. KETCHUM. The security issue is absolutely critical. That is why I say anything we look towards doing from this standpoint will be done without account information. And we are looking at the alternative information that we already have in place, what information may come someday with respect to the consolidated audit trail and evaluating those as alternatives as well.

Mr. HURT. Thank you, Mr. Ketchum.

I yield back my time.

Chairman GARRETT. The gentleman yields back.

The gentleman from California is recognized.

Mr. SHERMAN. I first want to pick up on the comments of the gentleman from Virginia and these Department of Labor standards.

We have kind of a choice. We can provide the maximum protection to investors and, in that way, eliminate investment choices. You can only invest in plain vanilla.

Or we can say, "You get a little protection, and you get a little more freedom, and you can invest."

We now have a system in which we provide—some would say more protection, some would say less options to my IRA than to my widowed mother's life savings.

Is there any reason why middle-class people controlling their brokerage accounts should have different protection standards, depending upon whether those accounts are IRAs? And if so, why would you provide—why are we developing a system to provide more of a straitjacket for me and less protection for my mother?

Mr. KETCHUM. First, I think it is a very fair question. I want to underline at the beginning, I am passionate from the standpoint of protecting investors, and I also agree with you that our system works because investors have a range of choice with respect to products built around a lot of requirements to ensure that what is provided to them is suitable.

I do agree with, I think, your central premise. I think any of us, when we go about investing, don't think about investing with respect to tax-advantaged accounts differently than we think with respect to our other investments.

And I think that a proper environment that properly protects investors builds the right level of disclosure requirements, the right focus with respect to the industry in managing their conflicts and ensuring those conflicts don't result in recommendations that harm investors, should look across products.

And that is why I have tried to say that I believe the right direction forward here, with great confidence in Chair White, is for the SEC to look and reach its determinations as the Dodd-Frank Act provided the capability across all products.

Mr. SHERMAN. I would hope that the agency that could provide the same level of logical protection and or options to both the IRA account and the widow's savings, would step forward.

We have had some frauds. Often, these frauds are perpetrated by well-mannered, well-dressed gentlemen. And then we have rules that seem to work only if someone behaves as a "gentlemen" in the standards of England a couple hundred years ago. For example, it is important that your—the broker-dealers be audited.

Do you make sure, when you get the audit report, that it was actually signed by the auditor by contacting the auditor? Or do you just need a good inkjet printer to forge the stationery?

And second, do you make sure that the auditor is large enough to handle that size client? If that had been done, of course, Bernie Madoff never would have gotten away with it. Do you take those two very elementary steps, which would be unnecessary if everybody behaved like a gentleman or a lady?

Mr. KETCHUM. Audits are important. I think the exams we produced—

Mr. SHERMAN. Do you do those two steps, those two simple steps?

Mr. KETCHUM. We do check with respect to the auditor. The PCAOB does have requirements as to what required levels of audits are and—register audits—auditors at this point.

We don't have any rules that restrict size of auditors with respect to—

Mr. SHERMAN. The accounting profession has a rule. It says you have to be independent, you have to be big enough to do the job, you have to be big enough to do the job without that job constituting 50 or 80 or 100 percent of your fees that you can generate in a year. So one person, a CPA firm, can't do it.

So you make sure that the auditors sign the report? You don't just take a look at the piece of paper and think that is good enough?

Mr. KETCHUM. No, we don't go back to each auditor.

Mr. SHERMAN. You don't bother. You trust everybody.

Mr. KETCHUM. If I can clarify, the PCAOB has a regular oversight coming out of Dodd-Frank with respect to all auditors.

Mr. SHERMAN. Yes, but they don't make sure that the report was actually signed by the auditor. Just all you need to do is steal a piece of stationery. It shouldn't be that tough if your name is Madoff.

But let me also ask you, you have this broker check system.

Mr. KETCHUM. Yes.

Mr. SHERMAN. You have a lot of people you are asking about possible bankruptcies, criminal convictions, et cetera. When I have a tenant, I can spend $50 and use a commercial service to make sure that the person reporting to me is telling me about bankruptcies, unlawful detainers, criminal—do you use that or is it just—or do you just count on the broker to tell you about these matters?

Mr. KETCHUM. No, we do both. We—the Commission has now approved a rule that requires additional broker checks before—by the broker at the time the employee comes in, and we do exactly those reviews and have just completed reviews of that across the entire broker check database.

Mr. SHERMAN. And do you have an integrated system, since many of the people who are with broker-dealers are also involved in other investments like real estate, insurance, et cetera, do you have a centralized system of all those who have been disciplined by the various State regulatory bodies that deal with real estate agents, insurance agents, et cetera?

Mr. KETCHUM. Those disciplinary reports are required to be reported as part of the U4. We would love to have a unified system but we don't have the jurisdiction to do that.

Mr. SHERMAN. Do you contact each State and get the data?

Mr. KETCHUM. We—the firms are required and the brokers are required to put it in. We would love to have it, and we have proposed it, but the States have been unwilling to have a uniform system.

Chairman GARRETT. The gentleman's time has greatly expired.

The other gentleman from California?

Mr. ROYCE. Thank you, Mr. Chairman.

I would just like to follow up on Mr. Hurt's comments and some of your thoughts, again, on this risk-based surveillance and how your early warning system would work. And I take it from your comments—and by the way, I share his concern about the way the CARD program was going. From your comments it seems there is a—do you still feel there is a way to collect data in the aggregate that is going to allow you to go forward without putting individual account level data at risk?

Could you explain a little bit more about the timing, how long this is going to take, and what you have in mind there?

Mr. KETCHUM. First and foremost, it will take whatever time it requires, and part of that whole decision is to whether we build a new system or not. One of the things we are doing, Congressman, is looking closely at the other information we have, the information we pulled down before exams and the information that is available from firms' financial reports to reach a decision.

But if we do move forward with any proposal, it will go back to our board. It will be put out as a new notice to the industry and to other segments, investors and the like, and all of that will be done with a public comment period before we make a decision, before the board makes a decision as to whether to file the rule with the SEC.

Mr. ROYCE. Thank you.

Mr. KETCHUM. I would say it would take a considerable amount of time.

Mr. ROYCE. And then the short question, I was going to ask you here about this United Kingdom rule that was implemented there last year to ban commission payments from mutual funds to brokers, and some of the statistics on that, about 310,000 clients stopped being served by their brokers because their wealth was too small for the broker to advise profitably. And then you had another 60,000 investors who were not accepted as new clients since then for that same reason.

And I was going to ask you, are these statistics concerning? And do you believe that the Labor Department's fiduciary duty proposed rule could lead to similar impacts here?

Mr. KETCHUM. I think the statistics are certainly concerning and should be part of the review of the Labor Department's rule. We are still in the process of reviewing the rule. I think the Labor Department made significant strides in creating a more balanced rule, but there are parts of the release and the description of broker-dealer business that we don't think is accurate.

So I completely agree with your premise that moving to an environment where fee-only advisory accounts are the only effective way to operate in the United States is a very bad step and that with respect to middle-class investors the availability of both—the choice between fee-only and commissions is important.

And any steps taken should look carefully at ensuring that type of environment remains in the United States.

Mr. ROYCE. And I would also ask you how you respond to criticism that SROs are becoming a fifth branch of government, and FINRA is starting to look a lot like a deputy SEC, as somebody said?

Mr. KETCHUM. I don't think we are anything like a deputy SEC. I do accept that FINRA has a unique position that is different than other self-regulatory organizations, and that—and with the merger with New York Stock Exchange regulation and our responsibilities, that does deserve very careful oversight.

FINRA is way different than a government agency. It has industry members on the board, it has the ability for informal access through committees and otherwise with regard to industry members. Those persons get the opportunity to look on an informal basis at any rule that we propose or are considering proposing. We respond to those comments and we also pass those comments onto our board.

So I think FINRA is an independent organization that is informed in a very effective way from the standpoint of industry concerns.

Mr. ROYCE. Let me ask you one last question. It appears that we are moving towards expansive quasi- or direct government regulation in retail securities markets. And I was going to ask if you think similar regulation is needed for private trading platforms known as dark pools or is there a difference, in your view, between regulation of retail markets and areas where sophisticated institutional investors are the market participants?

Mr. KETCHUM. That is an excellent question. I do believe there is need for greater transparency with respect to dark pools that are an integral part of the U.S. equity markets. And we, in fact, have had that occur from the standpoint of reporting requirements we have built in.

I believe there is a necessity for effective and aggressive oversight. And we try to provide that. I do think dark pools have a role in the complicated and sophisticated marketplace that we have, and we should ensure that role continues to occur and provides competitive balance and choice that is valuable.

But to your point, I think it is a good time and I am glad that the SEC has indicated their intention to step back overall and look at the equity market structure.

Mr. ROYCE. Thank you, Mr. Ketchum.

Thank you, Mr. Chairman.

Chairman GARRETT. The gentleman yields back.

The gentleman from Massachusetts is recognized.

Mr. LYNCH. Thank you, Mr. Chairman.

And thank you, Mr. Ketchum, for your willingness to testify and help the committee with its work.

I realized—there is some friction here that is underlying some of the questions here and that is I think because some people see you as an SRO and as an organization that is meant to serve your broker members, your members, and then some of us think that your overriding mission is really to protect the investor.

So let me posit something. Suppose you have brokers out there that are doing high-frequency trading. And they are chasing rebates and fees instead of pursuing best execution on behalf of the investors. Okay, so your members are chasing fees and rebates and the investor is being disserved by that practice.

Where is FINRA's loyalty? Are you protecting your members or are you protecting the investing public? That is the question.

Mr. KETCHUM. Our statutory responsibilities and our passion is investor protection and market integrity. That always comes first. High-frequency trading is not one thing. Much of it is proprietary and doesn't involve customer accounts, but you are right, some of them do.

Many are sophisticated, but the concerns around high-frequency trading is a huge focus of our surveillance program. And while much high-frequency trading is effectively market making in the—

Mr. LYNCH. Let me—I don't have a lot of time—

Let me just ask you that, though. You have raised a good point. In your current toolbox, are you able to properly surveil the conduct of high-frequency traders to make sure that in the course of executing those trades, the investor is getting the best execution?

Mr. KETCHUM. Where that manipulative activity would be occurring in either the equity market, fixed-income market, or options market, yes we do. And we have had for years surveillances particularly looking at things like spoofing, layering, marking the close, and wash sales and brought numerous cases.

You raised in your opening statement, Congressman, a valid concern with respect to the fact that we do not have a common jurisdictional program and a common program with regard to interest rate swaps and with regard to futures.

I would note for one thing it would be great if futures activity was included in the SEC's proposed consolidated audit trail.

Mr. LYNCH. Yes, let me just jump in here. This is—the SEC has stated that FINRA is unable to monitor the off-exchange market activity of non-member firms and detect potentially manipulative or other illegal behavior as efficiently or effectively as it can FINRA members. Do you agree with that?

Mr. KETCHUM. Yes. That relates to a recent SEC—

Mr. LYNCH. Are you operating with a full set of data?

Mr. KETCHUM. We would—where the consolidated audit trail goes, which includes customer information—

Mr. LYNCH. That is not up yet, though, right?

Mr. KETCHUM. No. The steps that the SEC is proposing—

Mr. LYNCH. I don't want to burn all my time here. I am just trying to get a sense of where you are at and where you might need help.

Mr. KETCHUM. Yes. The SEC has a proposed rule that addresses that and we support it.

Mr. LYNCH. Okay. And what is the timing on the consolidated audit trail? We have been doing this for several years and we are still some distance away, I imagine.

Mr. KETCHUM. I am on the other side of an information barrier. The exchanges and FINRA have filed a plan. The next step is for the SEC to publish it and that has not yet occurred.

Mr. LYNCH. Okay. In your recent brokerage inspections, FINRA found that some firms do not have active best execution committees. So I don't know if the firms themselves are actually paying as much attention as they should. Is there a way—now, you say we have some tools, although we are not acting—we are not operating with full or complete data. Is there a way currently where we can find out whether brokers are chasing the rebate and fees? Or—and that should show in a pattern or whether the preponderance of the brokers are actually providing best execution?

Mr. KETCHUM. One of the things we particularly look at is whether brokers can justify where they place most of their customer orders. As you know, they tend to route them often to a predominant market site and that is absolutely a concern of ours. Most firms do, but where firms don't, we look at the—at either changing behavior or enforcement actions.

Mr. LYNCH. Okay. Thank you. My time has expired. I yield back.

Thank you, Mr. Chairman.

Chairman GARRETT. Thank you.

Mr. Hultgren is recognized for 5 minutes.

Mr. HULTGREN. Thank you, Mr. Chairman. And thank you, Chairman Ketchum for being here today, as well. I would like to focus my comments and questions on the SEC and the Department of Labor, its effort to expand the definition of fiduciary which further extends Federal regulatory control into Americans' financial planning decisions. This move could restrict the number of investment products financial advisers could offer to their Main Street customers, making it harder for average Americans to invest. I have heard loud and clear from my constituents about the negative consequences of a fiduciary standard, including the tens of thousands of small investors throughout the district I represent, the 14th Congressional District of Illinois.

They tell me that this change would not represent true consumer protection but would, instead, make it harder for Americans to plan for their future, put money away for their children's education and invest. While customers need enough information and options from their financial adviser to decide what products they need, I believe there is a danger that a fiduciary rule would strip their ability to get advice and help.

This is why I co-sponsored the Retail Protection Investor Act, which delays the proposed rule until the Securities and Exchange Commission issues its own fiduciary rule and also requires the SEC to study alternatives to a uniform fiduciary standard and the impact of such a standard on everyday investors.

Fiduciary proponents argue that a higher standard is needed because the current broker-dealer supervision regime is insufficient. Mr. Ketchum, my questions are really to that. Given that FINRA plays a significant role in broker-dealer supervision, can you describe the current regulatory and compliance regime with which FINRA-registered broker-dealers must comply?

Mr. KETCHUM. Yes, Congressman. We have a rigorous examination program in which all members, depending on their size and complexity, are examined between once every year or 4 years. We regularly are oversighting from a surveillance standpoint to identify instances that suggest that there is a problem with respect to how they are operating.

We bring over a thousand enforcement cases a year. As was noted earlier, we provide referrals to the SEC with respect to regulatory concerns that are outside of our jurisdiction and we bar over 400 persons each year who are operating inappropriately from the standpoint of their position as registered persons.

We also have rules focusing on suitability and on supervision and on written supervisory procedures that provide a very strong environment for investor protection. I can't say that it couldn't be better, but I agree with you that the care has to be taken exactly as you describe, to—and it certainly would be preferable with my standpoint for the SEC to be the expert agency moving these type of issues forward.

Mr. HULTGREN. Let me dig a little deeper. What steps must broker-dealers take to ensure that their customers are not confused about broker-dealer services? Are broker-dealers required to disclose to the customers material information about potential conflicts of interest? Must they also refrain from engaging in certain transactions if potential conflicts are acute?

Mr. KETCHUM. Yes. The broker-dealers have an obligation to know their customers, evaluate their recommendations, ensure they are suitable and there are numerous obligations from the standpoint of disclosure, with respect to third-party payments or other issues from the standpoint that—where a conflict may exist, absolutely.

Mr. HULTGREN. Thank you. Even if investors are confused about the differences between broker-dealers and investment advisers, is the only solution to impose a fiduciary standard of care on broker-dealers? Would additional disclosure to investors better protect them? Are there other ways to improve disclosure without creating information overload or imposing unnecessary regulatory burdens?

Mr. KETCHUM. Yes. I think there are a number of ways. And I think it is a challenge for all of us from a regulatory standpoint to look for ways to increase the understandability of disclosure. And I think those are important points.

I would note that a large part of the best interest standard should fundamentally be ensuring that firms manage their conflicts and provide proper disclosure. It should always have the balance that you describe from ensuring that it also doesn't impose unnecessary cost.

Mr. HULTGREN. Yes. Fiduciary advocates have argued that FINRA has a conflict of interest in their supervision of broker-deal-

ers, which makes your supervision lenient. Can you respond to that?

Mr. KETCHUM. Yes. And it is just absolutely not true. We are funded—one of the upsides of FINRA is that we are not funded by taxpayer dollars. We are funded by user fees with respect to the industry. But industry members that do business with customers are required to be a member of a securities association. While they have the ability to start a new one, today there is only one, and that is FINRA.

Mr. HULTGREN. My time is almost up. I do appreciate your time here and bringing some clarity for me and for others hopefully here as well. As I do talk to advisers and broker-dealers that I know in Illinois, they certainly don't feel underregulated. Sometimes, they complain maybe that it is too much. But I think it is important, again, for that confidence to be there. So my time has expired. But thank you very much for being here and thank you for your help on these questions.

I yield back.

Chairman GARRETT. The gentleman yields back.

Going down to the very first row, Mr. Poliquin is recognized for 5 minutes.

Mr. POLIQUIN. Thank you, Mr. Chairman.

Mr. Ketchum, thank you very much. I appreciate your willingness to be here today. Thank you.

There are many of us on this committee, sir, and throughout Congress who are getting concerned about the expansion of regulators throughout our Federal Government. There are all kinds of examples of this, Mr. Ketchum, that are beyond the lines within which you operate.

For example: the Internal Revenue Service intimidating taxpayers, law-abiding citizens because they share different political views; and the EPA is repeatedly overreaching, making it more difficult for some of our companies, our manufacturing businesses, to grow and hire more people.

We had a fellow from the FDIC who was a regulator before our Committee about a month ago. And it was disclosed that the examiners at the FDIC are putting pressure on community banks to stop lending money to lawful businesses they deem undesirable, like firearms dealers or folks who sell tobacco.

And now we have the FSOC group that seems to want to put more and more taxpayers at risk in the event that a significant financial institution goes under. So it is a real concern of mine. And I come from the general industry that you are involved in now, sir.

Would you agree with me that when you increase regulations like this, you drive up fees, you drive up complexity, and those folks who are trying to save for their retirement and invest for their kids' college savings, that this could be an impediment to the choices they have with respect to the investment vehicles they want to have and the rates of return that they need to save for their kids' education and also plan for their retirement? Can we agree on that, sir?

Mr. KETCHUM. I can certainly agree on the goal. I can't speak to a—on a variety of other regulatory agencies, but I can tell you that is very much the goal from FINRA's standpoint. We don't want to

take any regulatory action where the burden exceeds the cost. And that seems to be a serious concern.

Mr. POLIQUIN. Good. And I also have a concern, Mr. Ketchum, that it looks like now the Department of Labor and the SEC are sort of competing over who in the heck is going to regulate the investment management community and the mutual fund industry. Why in the world would the Department of Labor want to get involved in that space where they have no experience regulating the investment business?

And to that end, if I may, now we have this discussion about imposing fiduciary standards on brokers. The same fiduciary standards that maybe a pension fund manager who is running $50 billion. We had a fellow here from Rockland, Maine, just over the border—I represent Western, Central, down east.

Mr. KETCHUM. Rockland, Maine, is beautiful.

Mr. POLIQUIN. Thank you, sir. I appreciate it. If you haven't been there recently, you ought to go back. And I appreciate that very much. But this gentleman came in. He is a broker in a small shop and he has about 200 customers. And his customers, they maybe move some snow in the wintertime. They do a little lobstering and they do a little bit of logging. And they are saving the best they can for their retirement.

And this fellow is very concerned because if these regulations get too burdensome on him, he is going to stop meeting with this couple that he is helping plan for their retirement. And all of a sudden, that advice leaves this couple, and his clients may become more subject to scams that could hurt their nest egg going down the road and put this couple more at risk to become more dependent on the government.

So don't you agree that it probably makes sense to have the folks at your organization who have the experience of regulating brokers—and I think you regulate 640,000 brokers across this country—don't you have the tools to continue to do this? Why do we need to have other folks like the DOL involved in doing something like this?

Mr. KETCHUM. Congressman, as I have indicated, I believe that this would be better if the SEC led and FINRA worked with them, to have a review across all products. And I think your concerns are very real and appropriate to be focused on. Of course, it is also important to look to where we can improve disclosures—

Mr. POLIQUIN. Sure.

Mr. KETCHUM. —and where we can improve handling of conflicts. But I agree that there has to be a careful focus. And I believe the SEC is the right agency.

Mr. POLIQUIN. Mr. Ketchum, will you commit today to me and to this committee that you will speak up loud and clear when it comes to other folks who want to go beyond their lines, such that the right people are making sure they regulate the right participants in this industry?

Mr. KETCHUM. I believe there should be a best interest standard, and I do believe the SEC should lead it. And everything I have said today, I have said earlier, and will continue to say.

Mr. POLIQUIN. And do you believe that the 640,000 brokers that you folks regulate are fairly regulated?

Mr. KETCHUM. Yes, sir, I do.

Mr. POLIQUIN. Okay. You don't think they need any additional fiduciary standards imposed upon them. Is that correct, sir?

Mr. KETCHUM. There are always opportunities to improve the regulatory structure—

Mr. POLIQUIN. Have you looked at the proposed regulations? Have you looked at the proposed rules coming out of the DOL, do you agree with them?

Mr. KETCHUM. We are still reviewing them.

Mr. POLIQUIN. And when will you make that decision?

Mr. KETCHUM. We certainly are considering the possibility of providing a comment letter to the Labor Department.

Mr. POLIQUIN. Okay. And I am also assuming that every time you consider a new rule imposed on any market participants that are trying to help our families save for their retirement, that you look at what the cost will be in imposing that new rule? Is that correct?

Mr. KETCHUM. Yes, sir, as well as the alternatives that may be less costly.

Mr. POLIQUIN. Great. Thank you very much for being here. I appreciate it.

I yield back my time.

Chairman GARRETT. Thank you for your questioning and your advertisement for Maine.

[laughter]

Mr. Hill is now recognized for 5 minutes.

Mr. HILL. Thank you, Mr. Chairman. And, Mr. Ketchum, it is nice to see you before the committee. I have certainly enjoyed my over 2 decades of friendship with you.

I want to associate myself with Mr. Poliquin's line of questioning. I thought it was excellent. Do you think that DOL has stepped outside their box? Their ball has landed outside the fairway in terms of the scope of what they are trying to do? In other words, they have the right to oversee a group retirement plan. No one argues with that, and they can set those standards. But what about the relationship between an individual investor in deciding to roll it into an IRA or what the composition of it is, and whether it is a fiduciary standard or not?

Mr. KETCHUM. My understanding is, they do have the jurisdictional ability to take that step. As I indicated earlier, I believe that while the investor protection issues around the decision to roll into an IRA are meaningful things that we have addressed, as you know, with respect to investor alerts and with respect to our exam and enforcement program, they are part of a wide range of issues for investors. And I think that there would be great value in looking at these issues from the standpoint of the SEC as the expert agency.

Mr. HILL. Would you commit to write a letter to the committee that outlines all the existing rules and regulations that govern investor protection in the retirement arena now that brokers and financial advisers are already living by that protect investors? Because I think it is extensive. I think your work there has been exceptional.

You were—FINRA was the first organization to lead a senior sweep effort of the financial industry. That was over a decade ago. And you have been focused on educating brokers and broker-dealers and managers on this issue for years. And I think it has demonstrated the results.

I think the committee needs to know that this is already being done, and that the DOL's effort is a redundant unnecessary exercise.

Mr. KETCHUM. Congressman, first, thanks for those words. And yes, we can certainly provide a description of all of our programs. I would be glad to.

Mr. HILL. Thank you.

I want to talk a little bit also about how small firms—of which you have many among your 4,000—have absorbed the Y2K hysteria process from FINRA. TRACE reporting, OATS and RTRS reporting. Mutual fund pre-sale planning, VA pre-sale planning, written whole documentation, which is the latest of the continuing hits from FINRA.

How do you balance—despite your Small Firm's Advisory Committee, how do you balance this issue that we are losing small firms like we are losing small banks? I think 3 percent or 4 percent of the firms exit membership every year. How sensitive is the agency to that? And how sensitive is the SEC to that?

Mr. KETCHUM. While I can't speak for the SEC, it is certainly a focus from the standpoint of FINRA. We care very much about the burden of our rules. In fact, one of the areas where we are taking initiatives now is the retrospective rule review. We have just done it and taken an initial proposal with respect to a variety of amendments to our advertising rules in response to that.

I think that we always have to keep analyzing the rules that are already in the books and determine whether they are imposing burdens across-the-board, particularly the small firms that could be less. We are going to do that with respect to our membership and change of business rules that you are very familiar with, I know, from your days in the industry—again, looking for ways to maintain the investor protection capability—benefits that come from those rules to reduce burdens.

Mr. HILL. I was pleased to hear you talk about the difference between the agency business and the fiduciary business. And one of my concerns across the regulatory system has been that we ignore the customer here. Washington consistently ignores the customer.

For 70 years, we have had a disclosure-based, caveat emptor, suitability, management-focused securities regulatory system, where the individual investors do have to take some responsibility for their own investments, wealthy or not wealthy. And some people want an agency-broker relationship, not a fee fiduciary relationship. They don't want it. They don't demand it. And yet, I feel like we are compelling and pushing the industry as if that is going to be a savior for something that I am not even sure what we are being saved from.

Would you elaborate just for a minute on this issue between agency business and fee or fiduciary-oriented business?

Mr. KETCHUM. Certainly, there are a variety of characterizations of fiduciary—

Mr. HILL. We want both, don't we, for our customers across the country—

Mr. KETCHUM. I think it is—

Mr. HILL. —whether they are rich or poor or middle income?

Mr. KETCHUM. I certainly think it is important for customers to have choices. And I think it is important that no steps are taken that reduce the ability for customers to choose—particularly who are relatively inactive—to have access to commission-based accounts. I do believe there are ways to improve the disclosure and management of conflicts today. But yes, it is very important to make sure that is balanced in a way that continues to allow customers to have choices.

Mr. HILL. I really think that it looks convenient to have a fee-based product for people, and that somehow commissions have this bad reputation. And yet, in many cases, I think if you were to analyze your account, the people on commission pay far less in managing their money on an annual basis potentially than someone who is on a—particularly, a small account—say under a half a million dollars would pay if they were in a fee account.

Mr. KETCHUM. I think that is a very real concern. And I think that for many customers, commission-based is—given the fact that they are maybe making a couple of transactions or investing in one mutual fund in a particular year—commission-based is absolutely critical to—

Mr. HILL. One final quick question. ETFs—when I was in the business, there were only maybe 100 funds and $100 billion. Now there are 1,600 funds and $1.6 trillion or so in exchange traded funds. Do you think it would be useful to have greater research—more access to research on exchange traded funds for retail investors?

Mr. KETCHUM. I know there is legislation that is put up there, and that has been a point made by a number of industry representatives. I do believe properly designed, an environment that encourages more research, addresses some of the Section 5 offering issues with regard to ETFs, where that is not—the research is not designed to push the ETF, but to provide sector-based information that allows investors to make better and more knowledgeable choices. That is certainly an area we would be very glad to talk with your office about and look for solutions.

Mr. HILL. Thank you, sir.

I yield back.

Chairman GARRETT. The gentleman yields back.

Mr. Messer, you are now recognized for 5 minutes.

Mr. MESSER. Thank you, Mr. Chairman. And thank you, Chairman Ketchum. I appreciate your testimony. I appreciate your stamina, as well.

I wanted to take a moment or two and talk a little bit about the importance of arbitration and ask for your comments. As you know, arbitration of broker-dealer disputes has long been used as an alternative to the courts, because it is a prompt and inexpensive means of resolving often complicated issues.

Broker-dealers advocate strongly for FINRA to continue its role as the primary forum for the resolution of consumer disputes in arbitration.

Some have claimed, as I know you are well-aware, that mandatory securities arbitration is unfair, and prevents retail investors from exercising their rights to a jury trial to resolve disputes. But the broker-dealers that I hear from back in Indiana believe that FINRA's direct market knowledge and your real world experience make you the best suited to continue the role as the primary forum for the resolution of consumer disputes in arbitration.

If the SEC—this is the question I want to get to—exercises its authority in Section 921(a) of Dodd-Frank, and either restricts or eliminates arbitration agreements, do investors win? Or do lawyers win?

Mr. KETCHUM. Congressman, I am very proud of our arbitration and dispute resolution system. I think it has sought to continue to improve, to continue to provide the right balance with respect to public arbitrators. And I think that any system that did not ensure that investors had access to that arbitration system would be a very bad impact on particularly middle-class investors.

Mr. MESSER. Yes. Do you have any reason to believe that securities arbitration contributed to the financial crisis?

Mr. KETCHUM. No, I don't believe securities arbitration contributed to the financial crisis at all. No system is perfect from the standpoint of its performance. But I think securities arbitration is in many, many ways very different from the rules around it from consumer arbitration otherwise. And I think it provides an independent, balanced, and fair resolution of concerns in a quicker and lower-cost environment for investors.

Mr. MESSER. Yes. And could you comment on any specific improvements that you tried to make at FINRA to deal with the consumer experience in arbitrations?

Mr. KETCHUM. I would be glad to. We have taken steps to improve the—and to address concerns with respect to the motion to dismiss in the discovery process. We have provided the capability for either side to demand an all-public panel that does not include anybody with respect to industry background.

We have also changed the definition of public arbitrator to ensure the absolute independence of those persons.

I believe that the steps taken and the input from both the industry and plaintiffs' lawyers have been enormously valuable. And the steps taken have been true positive steps for investors.

Mr. MESSER. I appreciate that. In my final minute or 2 here, some earlier testimony talked about the Equity Market Structure Advisory Committee. SEC Chair Mary Jo White has talked about trying to make that comprehensive and data-driven. I believe that you are a member—will be a participating member of that Structure Advisory Committee. Is that correct?

Mr. KETCHUM. That is correct.

Mr. MESSER. Starting on May 13th. And I think you already testified that you are looking forward to that, and believe it should be a holistic review of market structure.

Mr. KETCHUM. I am very much looking forward to it. And I think the regulatory steps the SEC has taken over the last 15 years on the whole have provided real benefit for investors. But the markets have evolved in ways that raise real concerns.

I was on an earlier advisory committee of the SEC and the CFTC when we made a number of suggestions to review, including on things like maker taker fees, often referred to as rebates. And I think this is a great time to step back and look at those issues, as well as look at the impact of SEC rules in the new market environment.

So, yes, I am very much looking forward—

Mr. MESSER. And in the limited time I have, I just—in that spirit of some of the suggestions you made there, would ask you about regulation NMS, which of course, many believe may be an underlying factor behind increased market fragmentation, the proliferation of ending trading venues, fee models, complex order types, and advanced trading strategies, including high-frequency trading.

Could you comment at all as to your belief in the impact of regulation NMS?

Mr. KETCHUM. Regulation NMS had many positive impacts from ensuring best execution and encouraging competition. But it certainly has resulted in more fragmented markets and it doesn't distinguish between marketplaces that are very, very small and other markets. So I think this is a good time to step back and look at Reg NMS. And I congratulate Chair White in including that as a key early focus of the committee.

Mr. MESSER. Thank you.

I yield back.

Chairman GARRETT. The gentleman yields back.

It looks like all the Members have asked questions. We obviously had a smaller number of Members here, I think due to the votes.

So, without objection, I would ask if a couple of other Members have any additional questions? No? No? No? I do. Just a couple.

And it sorts of throws off of Mr. Lynch's reference to the approach to SROs in general. I will put words in his mouth, and he was saying something to the effect of how some people want SROs to be regulated or be controlled by the industry, and other people want it to be more of not SROs at all, just a regulator doing things. And I think the answer is obviously somewhere in the middle.

So, two things. One, back at the end of last year, around October, the New York Exchange took back some of their authority—not their authority—took back some of the responsibilities that had been with FINRA since 2010, I guess it was, right?

And they are now setting up their own—what? Surveillance system, I guess you would call it. So they are going to be doing it all in-house, if that is the right—

Mr. KETCHUM. No, they are not going to be doing it all. They haven't begun anything. They took back on a going-forward basis looking at their floor-related New York Stock Exchange-only rules. We continue to do the cross-market surveillance for the New York Stock Exchange and all the markets. It allows us to look across markets to address and identify manipulative activity.

Chairman GARRETT. So exactly what are they taking back?

Mr. KETCHUM. They are taking back rules with respect to how orders are handled in the small amount of trading that occurs on the floor, and some of the New York-only rules that relate to how firms handle orders away from the floor.

Chairman GARRETT. So that is what they are doing now? So they are not—

Mr. KETCHUM. They are not doing anything now. We continue to do all of it now. They are in the process of building the surveillance capability to do that with respect to their own rules. Cross-market rules we will retain, and we are very grateful to New York that they have allowed us to do that.

Chairman GARRETT. Okay. And so they have no—because I am just going by press reports. The press reports seem to be more that they were going forward with more of a full surveillance system that they would be setting up eventually.

Mr. KETCHUM. The press reports overstated it. They will have a surveillance system for their own rules. It is not likely that will occur until the end of this year.

Chairman GARRETT. Okay. Ms. Peirce from the Mercatus Center, who was referenced earlier, discussed proposals to make SROs more shaped by, reflective of the industry, if you will—my words, not theirs. And she has had a number of proposals in that respect. And I didn't go through all of her proposals.

Are you familiar with that at all?

Mr. KETCHUM. I read Ms. Peirce's study some time ago, so I am not sure I am positive with respect to each one of them.

Chairman GARRETT. Okay. I am not going to go there at all.

But part of it is the broad 30,000-foot level to allow for—and this sort of follows off my NYSE statement—additional third-party entities to be able to compete, if you will, with FINRA to allow for, if we go down the road to additional standards as far as the industry is concerned, independent entities to be able to perform the examinations, as opposed to FINRA.

These are not new ideas. Can you just respond to those ideas?

Mr. KETCHUM. From the standpoint of market surveillance, obviously much of the responsibility—

Chairman GARRETT. Oh, not on the surveillance—

Mr. KETCHUM. Oh, but on examinations—

Chairman GARRETT. Examinations—right.

Mr. KETCHUM. —I think one person with respect to the lack of resources, the SEC and investor adviser side, Commissioner Gallagher has made I think very thoughtful suggestions about the part, and Chair White has indicated her interest and support about the possibility of third-party exams for investment advisers to deal with the fact that the SEC doesn't have the resources.

The statute itself allows any group of firms to set up a separate National Securities Association if they wish to have an alternative to FINRA.

Chairman GARRETT. Okay, so that would be for investment advisers. That is what they are talking about. Is that a—

Mr. KETCHUM. At least the proposals I know about are for investor advisers.

Chairman GARRETT. Right. Is that a possibility if they can flesh that out? Is that a possibility, then, to expand that over to broker-dealers as well, so you have a competing network, but both are regulated as well in the broker-dealer realm?

Mr. KETCHUM. I would view a possibility of for-profit, third-party examiners that are paid by the firm to do the exam, as a least-good solution.

Chairman GARRETT. That is the same situation you would have if Chair White goes ahead with—

Mr. KETCHUM. If there aren't enough resources, which certainly exists with respect to investment advisers, it is certainly better than nothing. I think having firms who are paid directly by the entity to do exams is—speaking of conflict of interest—a larger conflict that I wouldn't choose. I think it is much better for firms if they are not happy with FINRA to create their own national securities association, which they have the right under the statute to do.

Chairman GARRETT. With that, I will yield to Mr. Hill.

Mr. HILL. New Members of Congress get so little time to ask questions. I can't resist.

Chairman GARRETT. I yield the gentleman 30 minutes.

[laughter]

Mr. HILL. Plus, it is Friday. The staff has nowhere to go.

Mr. KETCHUM. We could do lunch if you want. I mean—

Mr. HILL. Just to follow up on Mr. Messer's point about arbitration, in your aging of arbitration cases from start to finish, have you seen the length of time to come to a conclusion and issue a decision lengthen out? Could you supply me sort of—I use the word "aging" analysis in a business sense, because I have heard from constituents about one year and then 2 years, and we don't have a decision. And the concept of speedy trial, even for an adviser that has a serious matter, is of concern to me.

Could you respond to that and provide some data on that?

Mr. KETCHUM. We would be glad to provide data. I think there was a challenge a few years after the credit crisis, I believe because of the good things about up-markets are there are less arbitrations. I don't think we have an aging problem now, but I can't speak confidently on that. We would be glad to provide you information.

Mr. HILL. And then just one other thing on my favorite subject, CARDS, and you know my personal views on the CARDS proposal in detail. I won't burden the world with them here.

But could you—it is my premise that FINRA can achieve the CARDS level intel with your existing authorities and your existing powers.

And so, through sweeps and through access of clearing firm data, you can certainly satisfy your curiosity about looking for patterns and potential fraudulent activity with that data stream you have now.

Isn't that accurate? At a big picture level, maybe not at the exact design level? And I am asking you as the CEO, not the IT director. So, even if your enforcement or IT people say it can be done—people told me that in my company all the time, but as chief executive officer, I didn't go along with them.

So I am curious, can't you achieve your public policy objective in a different way, if you didn't have CARDS?

Mr. KETCHUM. We could certainly achieve a lot. We can achieve a lot by using the data we have and the data that may become available over time more effectively, you are absolutely right there.

I would love to have more capability for an early warning capability to jump in on serious frauds and sales factor pieces. But, as I said in my written testimony, we are going to step back and look at all of that, because they are fair questions, and we should complete that analysis before making any decision.

Mr. HILL. Thank you, sir.

And thank you, Mr. Chairman.

Chairman GARRETT. Sure, thanks. So, that concludes today's hearing.

The Chair notes that some Members may have additional questions for this witness, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to this witness and to place his responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

Mr. KETCHUM. Thank you, Mr. Chairman.

Chairman GARRETT. Thank you very much.

With that, the panel is excused, and Mr. Ketchum, thank you. And this hearing is adjourned.

[Whereupon, at 12:10 p.m., the hearing was adjourned.]

A P P E N D I X

May 1, 2015

Testimony of

Richard G. Ketchum
Chairman and CEO
Financial Industry Regulatory Authority

Before the Subcommittee on Capital Markets and Government Sponsored Enterprises
Committee on Financial Services

U.S. House of Representatives

May 1, 2015

Chairman Garrett, Ranking Member Maloney and Members of the Subcommittee:

On behalf of the Financial Industry Regulatory Authority, or FINRA, I would like to thank you for the opportunity to testify today about FINRA's operations and the regulatory programs that support our mission of protecting investors and safeguarding market integrity.

FINRA

FINRA provides the first line of oversight for broker-dealers and the U.S. securities markets, and through its comprehensive regulatory programs, regulates the firms and brokers that sell securities in the United States. FINRA oversees approximately 4,000 brokerage firms, 161,000 branch offices and 637,000 registered brokers. FINRA touches virtually every aspect of the broker-dealer business—from registering individuals to examining securities firms; writing rules and enforcing those rules and the federal securities laws; informing and educating the investing public; providing trade reporting and other industry utilities; and administering the largest dispute resolution forum for investors, brokerage firms and individual brokers.

In addition to regulating brokers and brokerage firms, FINRA monitors approximately 99 percent of all trading in U.S. listed equities markets—or nearly 6 billion shares traded each day. In fact, FINRA's market surveillance systems process approximately 30 billion market events each day to closely monitor trading activity in equity, options and fixed income markets in the United States.

We also work behind the scenes to detect and fight fraud. In addition to our own enforcement actions discussed below, each year we refer hundreds of fraud and insider trading cases to the Securities and Exchange Commission (SEC) and other agencies. FINRA regularly shares information with other regulators, leading to important actions that can prevent further harm to investors.

Finally, more than 10 years ago, FINRA established the FINRA Investor Education Foundation to support innovative research and educational projects aimed at improving the financial capability of all Americans. Together with the Foundation, FINRA is committed to providing investors with information and tools they need to better understand the markets and basic principles of investing – and to help them protect themselves.

History and SEC Oversight

Self-regulatory organizations (SROs) like FINRA have always been a cornerstone of the federal securities laws. Even before the securities laws were enacted, the securities exchanges regulated their members. In 1934, Congress codified and strengthened the governance requirements that applied to the exchanges as it created the SEC. In 1938, Congress passed the Maloney Act, which extended the SRO model to broker-dealers who trade in the over-the-counter market. In doing so, Congress stated that reliance only upon direct regulation by the SEC "would involve a pronounced expansion of [the SEC's] organization . . . [and] a large increase in the expenditure of public funds . . ."[1] One of FINRA's predecessor organizations, the National Association of Securities Dealers (NASD), became a registered SRO as a result of the Maloney Act. In 1975, Congress again concluded that the SRO model "should be preserved and strengthened" as it amended the federal securities laws concerning the SEC's oversight responsibilities.[2]

FINRA provides significant investor protections through establishing licensing, registration and continuing education requirements, establishing rules requiring firms to develop and implement supervisory and compliance systems, and conducting regular examinations and surveillance to ensure compliance with existing laws and rules. SROs like FINRA also have flexibility to direct resources to large, multi-year technology development efforts that can support a variety of regulatory programs. SROs provide these benefits without significant additional cost to taxpayers, since they are typically funded by fees assessed on regulated entities.

Under federal law, the SEC oversees all aspects of FINRA's programs. For example, the SEC:

- approves FINRA rulemaking and seeks public comment on FINRA proposals through notice in the *Federal Register*;
- can abrogate, add to, and delete FINRA rules as it deems necessary or appropriate in furtherance of the purposes of the Securities Exchange Act of 1934 (Exchange Act);
- hears appeals of FINRA disciplinary actions, which also may be appealed to the federal courts;
- requires FINRA to keep records and file reports with the SEC; and
- inspects FINRA regulatory programs to ensure that FINRA is fulfilling its regulatory responsibilities and to mandate corrective action as needed.

Governance

FINRA has a Board of Governors (Board) composed of a majority of public governors, along with industry representation from various sectors of the business. This organization enables FINRA's Board, key committees and staff to act in the public interest while informed by a strong understanding of broker-dealer operations. As noted above, FINRA's activities are overseen by the SEC.

FINRA has 16 advisory committees, generally reflecting subject-matter expertise of the broader broker-dealer industry while also incorporating perspectives of academics and investor advocates. Each committee brings a unique perspective, and FINRA staff generally discusses significant rule proposals with relevant committees early in the rulemaking process. This

[1] S. Rep. No. 1455, 75th Cong., 3d Sess. I.B.4. (1938); H.R. Rep. No. 2307, 75th Cong., 3d Sess. I.B.4. (1938) (duplicate text quoted in both reports).
[2] S. Rep. No. 94-75, 94th Cong., 1st Sess. 7, II (1975).

typically includes discussion of the reasons for proposing the rule change, the committees' views on any potential burdens the rule change may impose, the benefits and practical consequences of such a rule change, and possible alternatives to the rule change that might achieve the same objectives. FINRA staff also discusses items to be considered by the Board with four advisory committees, including a Small Firm Advisory Board and an Investor Issues Committee which represents and provides feedback on the interests of the investing public.

FINRA Programs and Initiatives

FINRA's regulatory programs provide oversight of broker-dealer operations and markets to deliver protection to investors. The following sections provide descriptions of certain of those programs and current initiatives.

Examinations

Every firm and broker that sells securities to the public in the United States must be licensed and registered with FINRA. FINRA has a comprehensive examination program and regularly examines all firms to determine compliance with FINRA's rules and those of the SEC and the Municipal Securities Rulemaking Board (MSRB).

During a routine examination, FINRA examines core areas of the firm's business as well as aspects of the firm that present heightened regulatory risk. Specifically, FINRA examines a firm's books and records to see if they are current and accurate. FINRA analyzes sales practices to determine whether the firm has dealt fairly with customers when making recommendations, executing orders, and charging commissions or markups and markdowns; and scrutinizes a firm's anti-money laundering program, business continuity plans, and financial integrity and internal control programs. Similarly, firms go through a rigorous review for financial and operational compliance.

FINRA uses a variety of methods to better identify risk and decide where, how and with what intensity to apply our resources. We continue to enhance the exam process by applying a risk-based approach to both the frequency of exams and the areas where our examiners focus.

In 2014, FINRA conducted over 1,600 routine cycle examinations and 933 branch office examinations. We also conducted over 4,000 cause examinations, which are narrow, targeted exams that could be initiated due to complaints, tips, referrals or other specific issues.

In January 2015, FINRA issued its tenth annual examination priorities letter. In the letter, FINRA identifies specific areas of concern that will be a focus of examinations this year, including the sale and supervision of interest-rate-sensitive and complex products, such as alternative mutual funds, as well as controls around the handling of wealth events in investors' lives, management of cybersecurity risks and treatment of senior investors.

Municipal Advisors

In June 2010, Dodd-Frank Act amendments to the Exchange Act defined "municipal advisor" as a new type of entity regulated under U.S. securities laws, required municipal advisors to act as a fiduciary when dealing with municipal entities, expanded the MSRB's authority with respect to municipal advisors and required registration of municipal advisors with the SEC. Subsequently, the SEC issued a temporary rule requiring the registration of municipal advisors. In the adopting release for its final municipal advisor registration rules on September 20, 2013, the

SEC officially designated FINRA as the examination and enforcement authority for FINRA-regulated municipal advisors. Municipal advisor examinations began July 1, 2014 to coincide with the effective date of the SEC's municipal advisor registration rules.

Office of Fraud Detection and Market Intelligence

FINRA's Office of Fraud Detection and Market Intelligence (OFDMI) provides rapid response to allegations of fraud. OFDMI reviews regulatory intelligence from numerous sources, including tips, complaints and regulatory filings, to identify and expedite review of matters involving potential fraud or other serious misconduct. OFDMI's Whistleblower unit offers a telephone hotline and dedicated email box for individuals to report evidence of potentially illegal or unethical activity which is evaluated carefully and escalated for further investigation.

In addition, OFDMI conducts robust cross-market surveillance for potential insider trading and fraud, generating hundreds of referrals each year. FINRA and the SEC have an excellent partnership in this area.

In 2014, OFDMI referred approximately 700 matters including potential insider trading and fraud to the SEC and other federal or state law enforcement agencies. A recent example is the case of Matthew Carley of Bozeman, Montana who ran a so-called "pump & dump" scheme. FINRA developed evidence that was referred to the SEC identifying red flags of market manipulation in the shares of a microcap company called Red Branch Technologies, Inc. The FINRA referral included a series of suspicious press releases disseminated by Red Branch, promotional material found online and large sales of Red Branch shares by offshore accounts. The SEC conducted an extensive follow-up investigation and filed civil charges against Carley in December 2014 for fraud as he was secretly selling millions of Red Branch shares into the artificial market he created. Also, the U.S. Attorney's Office for the Eastern District of Virginia conducted a parallel criminal investigation and also filed charges against Carley. On April 3, 2015, Carley was sentenced to 24 months in prison and ordered to pay restitution of $2.3 million to his thousands of victims.

High-Risk Broker Program

Recognizing the potential harm individual bad actors can cause investors and the need to confront them quickly, in early 2013, FINRA launched its High-Risk Broker initiative to identify individuals for targeted, expedited investigation. Led by OFDMI, the High-Risk Broker initiative, which supplements our existing programs to evaluate complaints and conduct examinations, analyzes regulatory intelligence and structured data from a variety of sources, including broker termination filings, complaints, tips, arbitration filings, and field reports from ongoing examinations, to identify potential candidates for expedited review.

To date, over 140 registered persons designated as high-risk brokers have been barred from association with a broker-dealer. Importantly, the entire investigation and prosecution cycle for these cases averaged approximately 120 days from the time the individuals were designated as high-risk brokers. Two of these cases were completed in just eight days. This concentrated effort to identify individual potential problem brokers for expedited investigation is having a material impact in removing such persons from the securities industry.

For example, in January, 2015, FINRA began an investigation of a Beaumont, Texas-based registered representative after receiving a regulatory filing which raised suspicions about the

registered representative's role in unusual money transfers from customer accounts. Given the potential fraudulent conduct by the registered representative, he was designated as a high-risk broker. FINRA staff quickly examined the matter and obtained evidence that the registered representative converted $20,000 from one of his elderly customer's brokerage account through unauthorized wire transfers to an account belonging to the registered representative's mother. FINRA permanently barred the registered representative in February 2015, 20 days after he was designated a high-risk broker. The brokerage firm made the customer whole.

Enforcement

One of FINRA's key functions is the enforcement of FINRA rules, MSRB rules, and federal securities laws and rules. FINRA may initiate investigations from various sources, including examination findings, filings made with FINRA, customer complaints, anonymous tips, surveillance reports, referrals from other regulators or other FINRA departments and press reports.

In 2014, FINRA brought 1,397 disciplinary actions that addressed a wide variety of misconduct. Significantly, FINRA ordered $32.3 million in restitution to customers. These actions included two analyst cases—one finalized in November for a firm's failure to supervise communications between its equity analysts and its clients; and the other brought in December, for 10 firms allowing their equity research analysts to solicit investment banking business and for offering favorable research coverage in connection with a planned initial public offering. In addition to these monetary sanctions, there were 403 bars and 705 suspensions of individuals. Of these actions, the High-Risk Broker program accounted for 85 bars against individuals posing a particularly high risk of harm to investors.

Market Regulation

FINRA has responsibility to oversee and regulate over-the-counter (OTC) trading of exchange-listed and non-exchange-listed securities, as well as trading in corporate and municipal debt instruments and other fixed income instruments. FINRA also conducts examinations of market making and trading firms to assess compliance with FINRA trading rules and the federal securities laws. In addition, FINRA provides surveillance and other regulatory services to U.S. equity and options exchanges. FINRA has regulatory service agreements in place with 10 of the 11 U.S. equity exchanges and all U.S. options exchanges conducting market surveillance for approximately 99 percent of the listed equity market and approximately 75 percent of the listed options market. As a result, while the markets have become increasingly fragmented, through our contracts with exchange clients, FINRA has been able to aggregate trading data across the markets to conduct comprehensive, cross market surveillance. This is important because FINRA has found many instances where market participants have consciously dispersed their trading activity across multiple markets in an effort to avoid detection.

To conduct cross market surveillance, FINRA uses a variety of sophisticated online and offline surveillance techniques and programs to reconstruct market activity, using trading data and quote information that is captured second-by-second throughout the trading day, as well as order audit trail data reported daily. This cross-market surveillance enables FINRA, in partnership with exchanges and the SEC, to better protect investors and promote market integrity. FINRA also is starting to design surveillance programs that will span equities and options markets together for potential manipulative conduct.

FINRA also provides interpretive guidance on a variety of trading issues and rules, handles market-related complaints from investors, broker-dealers and other parties, and conducts market and trading-related preventative compliance activities.

As noted in FINRA's 2015 regulatory priorities letter, areas of focus for this year include potentially abusive trading algorithms, high-frequency trading (HFT), cross-market and cross-product manipulation, order routing practices, best execution and disclosure and market access controls.

Rulemaking, Economic Analysis and Retrospective Rule Review

FINRA's rulemaking process involves extensive public consultation well before a proposed rule change is filed with the SEC. In general, a significant FINRA rulemaking proposal will undergo four distinct steps before becoming effective, with external input at each step in the process. First, FINRA's staff obtains insights on possible actions by consulting with interested FINRA constituencies, including representatives of broker-dealers and investor advocates who are members of advisory committees.

Second, the proposal is submitted to the FINRA Board for consideration. Third, after the Board has approved moving forward with a rule proposal, FINRA, with respect to most significant rule filings, solicits public comments by publishing a Regulatory Notice. FINRA considers comments received and responds to the comments if FINRA subsequently files the rule proposal with the SEC.

The fourth step in FINRA's rulemaking process is filing a rule proposal with the SEC, which is published for comment in the Federal Register. As a matter of practice, FINRA responds to any substantive comment on the proposal received by the SEC, and the SEC considers these comments before it acts on a FINRA rule proposal. FINRA will often amend a rule proposal in response to comments before seeking final SEC approval. All rulemaking documentation is available to the public on the FINRA website.

In September 2013, FINRA published a statement that lays out its framework for evaluating the economic impacts associated with its rulemaking, aimed at ensuring that proposed rules are better designed to protect the investing public and maintain market integrity while minimizing unnecessary burdens. As part of the rule development process, FINRA describes the economic impacts associated with proposed rulemaking and seeks information to help refine its evaluation at each step. The Office of the Chief Economist works to integrate economic impact analysis into proposed rulemaking, implement retrospective rule reviews and conduct research and analysis.

Retrospective Rule Review

In 2014, FINRA launched its retrospective rule review initiative to periodically look back at significant rulemakings or rule sets to ensure the rules remain relevant and appropriately designed to achieve their objectives, particularly in light of environmental, industry and market changes. Through these reviews, FINRA hopes to identify duplication or overlap between related rules, improve its administration of rules, and identify significant regulatory gaps where they might exist.

Once a rule or rule set is selected for review, we request comments and feedback on fundamental questions about the effectiveness of the rules in addressing the problem(s) they were intended to mitigate, what experiences or challenges firms have had in complying with the rules, what the economic impacts of the rules have been, and if there are ways to increase the efficiency and effectiveness of the rules or process related to the rules. We also reach out to a cross section of industry representatives and other persons experienced with the rules to obtain their detailed feedback about how well the rules are working. In addition, we seek to validate and prioritize the views we have obtained by consulting with, among others, FINRA's advisory committees and by conducting a survey of regulated firms administered by the Office of the Chief Economist.

The initial two reviews conducted last year covered rules related to communications with the public and rules related to gifts, gratuities and non-cash compensation. Reports on these reviews were released in December 2014. We are developing proposed rule amendments to reflect the recommendations in those reports, as well as potential guidance or administrative changes to update and increase the efficiency and effectiveness of those rule sets. Initial proposed changes to the communications with the public rules were approved by our Board in April. FINRA recently launched its next retrospective review, on rules related to our membership application process.

Market Structure-Related Initiatives

SEC Chair Mary Jo White has set out a road map for potential future changes in the equity and fixed income markets, which specifically includes an important, ongoing role for FINRA and other SROs.

Equity Markets

In the area of equity trading, recent rulemaking efforts have been focused on automated trading activities, including HFT, with three primary objectives: first, to enhance our ability to monitor automated trading including the type and quality of information and data FINRA receives; second, to provide market participants and investors more transparency into trading activities; and third, to ensure that firms engaged in automated trading activities and their employees are properly trained, educated and accountable for their activities. FINRA's proposals call for alternative trading systems (ATSs) to provide more in-depth quoting information for regulatory surveillance, tighter restrictions around allowable clock drift to better ensure proper sequencing of events, greater transparency of volume executed away from stock exchanges, registration requirements for persons involved in the design, development and significant modification of trading algorithms, and more granular audit trail information.

These rulemaking efforts properly focus FINRA's role and resources where they can have the most impact, while supporting the SEC's efforts. Each of these proposals has been published in a Regulatory Notice to provide an opportunity for more in-depth feedback and economic impact analysis prior to filing the proposals with the SEC.

Fixed Income Markets

In the area of fixed income securities, we have been working closely with the SEC and MSRB to develop ways to enhance transparency and execution quality in the fixed income market.

We recently solicited comment on a proposal to require that additional pricing information be provided to customers on their trade confirmations in corporate and agency debt securities. Putting additional pricing information in the hands of customers will better enable them to evaluate the cost and quality of the services firms provide and encourage communications between firms and their customers about their fixed income transactions. We are in the process of carefully evaluating the comments we received on this proposal.

To inform FINRA's regulation of and strengthen its ability to conduct surveillance of fixed income trading, FINRA also is requesting comment on a proposal to require ATSs to report to FINRA quotation information for corporate and agency debt securities. While there has been significant growth in the availability of automated quotations for fixed income securities, broker-dealers are not required to routinely report that quotation information to FINRA for regulatory purposes. As a result, unlike the listed equities markets where FINRA receives consolidated information on quotations, FINRA does not have ongoing access for surveillance purposes to ATS quotation information for fixed income securities. This rule proposal would be a first step to provide FINRA with better insight into the scope and accessibility of pre-trade transparency in the fixed income markets.

Similarly, in recognition of the significant changes that have occurred in the fixed income market, we plan to publish guidance on firms' best execution obligations relating to transactions in fixed income securities. This guidance will, among other things, reiterate firms' overall best execution obligations and emphasize the importance of evaluating the availability and accessibility of electronic systems and how such systems can provide benefits to their customer order flow to ensure they receive the best prices reasonably available.

Special Purpose Broker-Dealers

We are narrowing the rules that apply to firms whose business is limited to advising companies on capital raising and corporate restructuring. These broker-dealers serve small and middle-sized businesses and do not raise the same issues as broker-dealers with a wider scope; we are adjusting the rule set to reflect these differences.

JOBS Act Implementation

In order to fulfill our mandate under the JOBS Act crowdfunding provisions, we plan to file our proposed rule set applicable to crowdfunding portals immediately after the SEC adopts its Regulation Crowdfunding. FINRA has streamlined the already limited set of rules that would apply to funding portals. We intend for these rules to be in place by the time the SEC's proposed Regulation Crowdfunding goes into effect.

Comprehensive Automated Risk Data System (CARDS) Proposal

While existing tools at FINRA's disposal are used effectively to protect investors from sales practice abuse, they depend primarily on periodic examinations. In contrast, for years we have received regularly from FINRA-regulated firms transaction information allowing FINRA to monitor market integrity, and financial information allowing FINRA to monitor firms regarding compliance with financial requirements. Similarly, the concept motivating the CARDS proposal is that by enhancing our access to data and analytics, we can evolve our risk-based surveillance and examination programs regarding sales activities. This would operate as an early warning system to more effectively identify potential fraudulent activity and customer sales practice abuse to guide examinations. Accordingly, we believe that a data-driven analysis could

increase our ability to identify investor protection issues sooner and to respond quickly to stem investor harm.

We are currently in the process of evaluating the many comments we received in response to the CARDS proposal and are meeting with industry and investor groups as well as individual firms to ensure that we understand all the concerns raised. Even though we are not proposing to collect personally identifiable data (such as name, address and social security number) as part of this initiative, we understand and share the concerns raised around the potential ability of bad actors to access information that could possibly be reengineered to identify individuals. As a result, we are conducting additional analyses, engaging third-party experts to further analyze these threats and exploring alternative approaches with interested parties. We also are reviewing the feasibility of meeting the important goal of enhancing our early warning capabilities regarding fraud and investor abuse using existing data sources and the data that will become available when the Consolidated Audit Trail is implemented. To be clear, we will not move ahead with the present form of the proposal and will not move forward with an amended version until we conclude that the concerns raised in the comments have been addressed.

Transparency

FINRA operates OTC market transparency facilities that provide the public and professionals with timely quote and trade information of publicly traded equity and debt securities. They are the primary source for regulatory data on these transactions, and provide FINRA-registered firms with tools to comply with reporting obligations in secondary-market activity in fixed income and equity securities.

Trade Reporting and Compliance Engine® (TRACE®)
TRACE was established in July 2002 to provide trade price information to market participants in the fixed income market and to create a regulatory database for surveillance and oversight. It has had a major impact on the way fixed income instruments trade and has significantly improved the efficiency of these markets. Academic research has indicated that TRACE reduced corporate bond spreads – the difference between the price an investor can buy and sell a bond – by approximately 50 percent and has increased the consistency of pricing of mutual funds by reducing the variance in marks to market for their underlying instruments.

The initial product focus was corporate bonds and has since been expanded to include agency debentures and mortgage backed securities that trade TBA or as specified pools. In June we will expand transparency to include asset backed securities or fixed income instruments that are backed by such things as car loans. FINRA intends to introduce additional transparency to the last remaining portions of the securitized product universe when it releases data for collateralized mortgage obligations and similar securities during the next 12 to 18 months. These steps will result in TRACE providing trade price information to the public and professionals for over 1.4 million securities and approximately $300 billion in daily trades.

FINRA has developed an approach to providing transparency that permits a careful assessment of the impact of transparency on markets, allows market participants an opportunity to adjust to transparent markets, provides comprehensive information for regulatory activities at the earliest possible time and allows the private sector to build data products without competition from FINRA. The critical steps in the FINRA approach are (1) collecting all transactions at the beginning to provide a foundation for regulatory activities and an understanding of the market and (2) phasing in dissemination of trade prices to assess the impact of the transparency on the

market with academic partners and to provide market participants time to adjust to transparent markets. FINRA provides the basic data to the private sector to create added value products. This phased-in, analytical and consultative approach to transparency has been well received by regulators, market participants and data providers.

Dark Pool Volume Transparency Initiative

With over 30 percent of total national market system (NMS) volume now being executed off of the U.S. exchanges and with nearly half of that volume being executed by so called "dark pool" ATSs, FINRA, in consultation with the SEC, recognized the clear need for greater transparency regarding these OTC dark trading venues. To that end, in June 2014, FINRA began posting weekly on its website reported volume and trade count information for all dark pools. Market participants, investors, regulators and academics are now able to see with unprecedented granularity volume information and trends regarding dark pool trading on a security-by-security basis. FINRA is currently considering expanding the transparency initiative by publishing the remaining half of equity trading volume executed OTC by all firms on a security-by-security basis. Ultimately, the proposal would provide greater transparency to the marketplace with respect to the full range of trading activity that is currently taking place off of the U.S. exchanges, augmenting the dark pool volume that FINRA is currently making publicly available.

Dispute Resolution

FINRA operates the largest securities dispute resolution forum in the world to assist in the resolution of monetary and business disputes between and among investors, brokerage firms and individual brokers. FINRA's Dispute Resolution program provides investors and markets with a fair, efficient and economical alternative to costly and complex court actions which are often cost-prohibitive for investors with small claims. FINRA offers both mediation and arbitration services.

Since 2011, FINRA's program has provided investors the opportunity to select all public panels for arbitrations. The all public panel option ensures that no investor will have an arbitrator affiliated with the securities industry unless he or she voluntarily chooses one. In addition, several recent rule amendments have narrowed the definition of a public arbitrator. The most recent change establishes a bright line test that prevents anyone who has ever worked in the financial industry from serving as a public arbitrator.

FINRA's program has several other features that distinguish it from other private arbitration forums. FINRA's program charges significantly lower arbitration fees to investors than other forums, uses an investor-friendly discovery guide, and offers 71 hearing locations, including at least one in every state. Our Motion to Dismiss Rule ensures that investors in arbitration have a full opportunity to argue their case by limiting motions made prior to the investor resting his or her case, and provides for sanctions for frivolous motions and abusive motion practices. FINRA has the authority to suspend firms and registered representatives that fail to pay arbitration awards or agreed-upon settlements.

In July 2014, FINRA formed a Task Force to consider possible enhancements to its program to improve the effectiveness, transparency, impartiality and efficiency of FINRA's dispute resolution forum for all participants. The Task Force will make recommendations to FINRA's National Arbitration and Mediation Committee by December 2015, and FINRA will expedite a review of those recommendations.

Registration and Disclosure

FINRA operates and maintains the central licensing and registration system for the U.S. securities industry and its regulators. The Central Registration Depository, CRD®, developed in concept by FINRA and the North American Securities Administrators Association (NASAA), was introduced in 1981 and established a framework of uniform registration forms, one-stop form filing and fee collection, and a single regulatory database and registration processing system to meet the requirements of all participating securities regulators. CRD automates and supports the registration, qualification, disclosure and continuing education rules and regulations of FINRA, other SROs, the SEC and state regulators. Policy governing CRD is jointly established by FINRA and NASAA under SEC oversight.

FINRA's BrokerCheck® system makes available to the general public registration, licensing and disciplinary information on nearly 1.3 million current and former securities brokers and about 21,000 firms currently or formerly registered with FINRA or a national securities exchange. Implemented by FINRA in 1988, BrokerCheck allows investors to check the professional background, business practices and conduct of securities firms and investment professionals, thereby helping investors make informed choices about the individuals and firms with which they conduct business.

Investor Education

Investor education is a potent form of investor protection, and FINRA's Office of Investor Education provides an array of educational opportunities to investors. Through *finra.org,* publications and investor outreach, FINRA provides free, unbiased information and tools to help investors protect themselves and better understand the markets and basic principles of investing. Examples include FINRA BrokerCheck, the Fund Analyzer, the Risk and Scam Meters and a wide array of Investor Alerts, podcasts and online content focused on steps for choosing financial professionals, understanding different investment products, how to plan for the future, including smart 401(k) investing and saving for college, and more. FINRA also offers information for displaced workers on the financial impact of job loss, and tools for employers who want to help protect and grow their employees' retirement savings.

In 2003, FINRA established the FINRA Investor Education Foundation, which aims to provide underserved Americans with the knowledge, skills and tools necessary for financial success throughout life. The FINRA Foundation awards education and research grants and develops targeted programs aimed at segments of the investing public that could benefit from additional resources, such as military service members and senior investors. Since inception, the FINRA Foundation has approved nearly $100 million in financial education and investor protection initiatives through a combination of grants and targeted projects – and these efforts have led to tangible benefits for individuals and families in all parts of the country. The Foundation leverages its resources by working closely with dedicated grantees and project partners – people and organizations committed to building bridges between communities and the resources and financial education they need and want. By collaborating with others, the foundation maximizes the value of every dollar spent. Looking ahead, the Foundation aims to strengthen its partnerships through training, research and program delivery.

Consolidated Audit Trail

In July 2012, the SEC adopted Exchange Act Rule 613 requiring 19 SROs—FINRA and the 18 national securities exchanges—to work together to jointly file a NMS plan to govern the creation, implementation, and maintenance of a consolidated audit trail, or CAT, which will collect information on virtually every order and trade in equity securities and options in the United States. The CAT will be the world's largest repository of securities data, processing approximately 58 billion records on a daily basis. FINRA strongly supports the SEC's action to require the development of the CAT, an important initiative that will enhance regulators' ability to conduct surveillance of trading activity across multiple markets and perform market reconstruction and analysis. Comprehensive intermarket surveillance is essential to ensuring the overall integrity of the U.S. securities markets and maintaining the confidence of investors in those markets.

The SEC approved a NMS plan filed by the SROs establishing a formal process for the selection of the CAT Plan Processor. This plan includes multiple requirements designed to mitigate potential conflicts of interest, including those that may arise from an SRO also bidding to be the CAT Plan Processor.

FINRA, partnering with the Depository Trust and Clearing Corporation (DTCC/Kingland Systems) and using Amazon Web Services infrastructure, submitted one of the 10 bids in response to a request for proposals for the role of CAT Plan Processor. As a result, FINRA has two distinct and independent roles with respect to the development of the CAT: its role alongside the other SROs to meet their collective obligations under Rule 613, as well as party to a pending bid to serve as the CAT Plan Processor.

In addition to adhering to the requirements set out in the selection plan to mitigate potential conflicts of interest in the event an SRO was also a bidder, FINRA implemented a communications firewall, with specifically identified staff assigned to either the SRO consortium work or the bid work. The policies and procedures related to the firewall are designed to prevent the members of the SRO consortium side and the bid side from communicating with one another about non-public matters regarding the CAT. In addition, FINRA determined to abstain from all further votes involving the selection of the CAT Plan Processor as long as FINRA's bid remains under consideration by the SROs.

Conclusion

FINRA appreciates this opportunity to discuss its programs with the subcommittee. We remain committed to working closely with other regulators, this subcommittee and the full committee as we continue to work toward our dual mission of protecting investors and safeguarding market integrity.